

TESTIMONY OF

**THOMAS E. HOMMEL, MANAGING DIRECTOR
LEHMAN BROTHERS INC.**

**“ONE BROKER GONE BAD:
PUNISHING THE CRIMINAL, MAKING VICTIMS WHOLE”**

**BEFORE THE SUBCOMMITTEE ON
OVERSIGHT AND INVESTIGATIONS,
COMMITTEE ON FINANCIAL SERVICES**

UNITED STATES HOUSE OF REPRESENTATIVES

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Lehman Brothers Inc. (“Lehman”) is an investment banking firm that has operated for over 150 years, and currently employs over 13,000 persons worldwide. Lehman principally serves institutional clients, with its limited activities for individual investors being focused on serving high-net worth individuals through approximately 475 investment representatives.

Frank Gruttadauria worked for Lehman for only fifteen months. His employment resulted solely from Lehman’s acquisition of certain retail customer accounts and branch offices from S.G. Cowen & Co. (“Cowen”) in October 2000. That acquisition included eight different branch offices employing approximately 90 investment representatives servicing over 60,000 customer accounts. Mr. Gruttadauria was an investment representative in the Cleveland, Ohio branch office at Cowen, and had also served as the manager of that office for about ten years. He serviced approximately 470 customer accounts.

The Cleveland branch also employed an Administrative Manager, who was fully licensed to serve as a branch manager and had supervisory responsibilities over all customer activity in the Cleveland branch, including for customers serviced by Mr. Gruttadauria. In addition, the branch employed an Operations Manager who was responsible for various cashiering functions, including the disbursement of funds from customer accounts. At the time of Lehman’s acquisition of the Cowen branches in October 2000, the Administrative Manager and the Operations Manager of the Cleveland branch each had over ten years of experience in their respective positions at that branch.

Prior to Lehman’s acquisition of the Cowen branches, it performed due diligence with respect to Cowen’s personnel and operations. That due diligence disclosed with respect to

Mr. Gruttadauria that he had a spotless compliance record with not even a single customer complaint against him. Nor were there any significant number of customer complaints in the entire Cleveland branch. Although a New York Stock Exchange audit in 1994 and 1995 of several Cowen branches, including Cleveland, had revealed certain deficiencies in certain procedures, Cowen had entered into a settlement with the New York Stock Exchange in July of 1998 whereby it agreed to correct those deficiencies, none of which was related to the specifics of Mr. Gruttadauria's scheme. As part of its due diligence, Lehman was provided a report that was prepared by a prominent New York law firm, as mandated by the New York Stock Exchange, which set forth the corrective actions taken and the law firm's opinion that such actions were reasonably designed to prevent the recurrence of the noted deficiencies. In fact, in a prior submission to the New York Stock Exchange by that same law firm it stated: "Mr. Gruttadauria manages an exemplary Branch...At no time has the Cleveland Branch been the subject of any disciplinary action by a regulatory authority while Mr. Gruttadauria has been at the helm." Thus, Lehman's due diligence prior to the acquisition of the Cowen branches did not reveal any facts which raised any issues with respect to Mr. Gruttadauria himself, and those issues that had been raised about Cowen had been certified as having been fully addressed and remedied.

As part of the acquisition, Lehman also provided extensive training to former Cowen personnel regarding Lehman's policies and procedures. With respect to the Cleveland branch, this training took place through personal meetings in New York, Chicago, and Cleveland, numerous conference calls and the dissemination of various written materials.

As part of that transition, all 4,900 Cowen accounts in the Cleveland branch were to be reopened as Lehman accounts, thereby bringing them within Lehman's system of supervisory

procedures. What Lehman did not know at that time was that approximately 40 of these accounts that were serviced by Mr. Gruttadauria had what are now alleged to be fictitious addresses.

At the cornerstone of supervisory procedures for every broker dealer is the ability independently to send to all of its customers confirmations and monthly statements reflecting all activity in their accounts. Thus, this fundamental supervisory tool had been taken away from Lehman, without its knowledge, as a result of purchasing accounts that had defective addresses.

Moreover, nothing about the addresses that were on these accounts that are now at issue appeared suspicious in any way. In virtually all instances, the addresses appeared to be accounting firms or law firms, which presumably had been employed by the high-net worth client, or otherwise contained street addresses. Indeed, there is nothing unusual about high net worth individuals directing their brokers to send account statements to lawyers and/or accountants. One of the accounting firms listed had a post office box included in the address, while another one was in fact an actual accounting firm with its actual street address listed.

Customers for whom the actual statements were diverted received phony monthly statements and related tax information that were apparently prepared by or at the direction of Mr. Gruttadauria utilizing personal computers that he caused to be networked together and which were located at his office, his home and the home of his assistants. In addition, approximately 19 individuals received phony statements for accounts when there was no such actual account maintained at Lehman. A number of these customers who received phony statements also received actual statements that were different in appearance from other accounts that they maintained at the firm. Moreover, unlike any accounts which reflected the correct address, customers for whom the real statements had been diverted never received confirmations for any

transaction conducted in that account, contrary to the custom and practice of the brokerage industry.

In January 2002, Mr. Gruttadauria fled and notified the FBI of his scheme, which he claimed had gone on for 15 years, long pre-dating any affiliation with Lehman in October 2000.

We believe that the supervisory policies and procedures at Lehman caused ever increasing difficulty for Mr. Gruttadauria to perpetuate his scheme during the short period of time he was there for the following reasons:

1. Lehman's Supervisory Structure.

Lehman's supervisory structure is designed to provide numerous independent checks and balances. The Administrative Manager of the Cleveland branch not only reported to Mr. Gruttadauria, but he also had a reporting line to the Regional Administrative Manager located in Chicago and would interact with the Compliance Department in New York on an ongoing basis. For example, each month he was required to certify in writing to the Compliance Department that he performed each of the supervisory functions that he was responsible for, as well as to confirm in writing the steps he had taken with respect to accounts noted on certain exception reports. Moreover, he met one-on-one with the Compliance Department auditor during inspection visits to the branch in order to review activity in the branch and to enhance procedures.

Similarly, the Operations Manager also had a direct reporting line to the Head of Branch Operations for the firm, and would regularly interact with her.

In order to ensure that a branch manager like Mr. Gruttadauria could not exercise any undue influence, any bonus compensation for the Administrative Manager and the Operations Manager was finally determined by upper management outside of the branch together with Human Resources, not by Mr. Gruttadauria, whose role was limited only to input. Moreover,

under Lehman's policies, Mr. Gruttadauria was prohibited from making any significant gifts or loans to other employees, and he was required to certify each year that he was in compliance with that specific policy. He did so in February 2001.

Thus, under Lehman's policies and procedures both the Administrative Manager and Operations Manager of the Cleveland branch were thoroughly trained, and had separate and independent reporting lines outside of the branch.

2. Procedures With Respect to Change of Addresses.

Lehman's policies with respect to changes of addresses by customers require a signed authorization by the customer. However, in addition to that authorization, the firm's computer system automatically generates a notification that is sent by the firm out of New York to the customer's old address notifying him or her of the change in address. That additional procedure was not in place at Cowen.

Thus, Mr. Gruttadauria at Lehman was limited in his ability to obtain new funds to perpetuate his scheme since he was no longer able to change addresses for customer accounts without detection, even if he forged the letter of authorization.

3. Enhanced Monitoring of Customer Activity.

Lehman's system with respect to monitoring activity in customer accounts involves progressive levels of customer contact as activity increases.

For example, all customers should be receiving confirmations and account statements reflecting all activity in their accounts on a contemporaneous basis. As activity in an account reaches certain levels, the Compliance Department requires that a letter be sent to the customer to acknowledge that the transactions in his or her accounts are authorized and in accordance with their investment objectives. The letter is sent by the Administrative Manager and must be signed and returned by the customer. Moreover, additional activity by the customer may cause the

Compliance Department to require the Administrative Manager to establish direct personal contact with customers to discuss their trading, and to confirm in writing to the Compliance Department the substance of that communication.

By March 2001, one of the accounts, wherein it is now known there was a significant level of alleged misappropriations, had triggered a request by the Compliance Department for a letter to be sent confirming the authorization of all transactions. By November 2001, the Compliance Department also requested the Administrative Manager to personally contact the client to discuss the activity in his account. The Administrative Manager certified to the Compliance Department in writing in May 2001 that he had received a signed letter from the customer confirming the transactions in his account, and then again on November 29, 2001 he certified in writing to the Compliance Department that he actually spoke to the customer about his account activity, including the withdrawal of funds. No irregularities were noted by the Administrative Manager at that time; however, the customer now claims he never received the actual statements for this account, which were sent to an actual law firm.

These types of direct customer contact on an ongoing basis would render it highly unlikely for Mr. Gruttadauria's scheme to be able to continue without detection, even though the confirmations and monthly statements had been diverted.

4. Internet Access.

During 2001, Lehman was providing more and more customers with Internet access to their accounts, so that they could instantaneously see the current status of that account. In fact, one of Mr. Gruttadauria's clients in late 2001, who was receiving phony statements, was attempting to establish such access and Mr. Gruttadauria was attempting to deflect him.

This Internet feature not only provides greater customer service, but also enhanced supervisory controls, which in this case also increased the likelihood of detection.

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Perhaps the best evidence that all of these policies and procedures were putting enormous pressure on Mr. Gruttadauria is the fact that when the Administrative Manager mentioned to him in December 2001 the upcoming Compliance Audit in February or March of 2002, Mr. Gruttadauria reacted by stating that “he would probably be out of here by then.”

On January 17, 2002, the very same day Lehman learned about the alleged misappropriations, it sent a new management team to Cleveland, as well as various other personnel to immediately meet with clients. Lehman also immediately notified its regulators and has fully cooperated with the numerous inquiries it has received from those regulators and other governmental entities. The complete former management team of the office was replaced, all of Mr. Gruttadauria’s clients were immediately contacted to ensure that they knew precisely what was in their accounts, and meetings were conducted with the affected customers to fully share with them what information the firm had regarding their accounts.

Moreover, Lehman has already paid substantial sums to certain customers to reimburse them for funds misappropriated from their accounts while at Lehman, without even requiring a release from these customers. Lehman believes that the amounts already paid represent a substantial portion of any funds that may have been misappropriated while Mr. Gruttadauria was employed by Lehman, and is continuing in its efforts to identify and reimburse any remaining customers for any such misappropriations that may have occurred at Lehman.

Lehman unfortunately was in the unenviable position of having to tell these customers that they were not worth what they thought they were, but substantially all of the alleged inflation in their account value and substantially all of the alleged misappropriation took place prior to them ever becoming customers of Lehman. At the time that Lehman acquired the

accounts from Cowen which had the fictitious addresses, there was only approximately \$4.6 million in those accounts while the phony statements for those accounts at that time reflected a market value of over \$260 million.

Lehman, as part of its 150-year tradition, places an enormous premium on earning the trust and confidence of its clients. It regrets deeply that these events took place, but also firmly believes that its systems of supervisory procedures are more than reasonably designed to prevent and/or detect this type of activity. What happened here was truly unique in that Lehman, by purchasing accounts with defective addresses, had taken away from it without its knowledge one of the principal supervisory tools utilized throughout the industry -- the ability to independently send to customers confirmations and monthly statements which reflect all activity in their accounts. Notwithstanding that fact, Lehman's overall systems of supervision continued to tighten the noose around Mr. Gruttadauria's activities so that what apparently had gone on for fifteen years was unable to continue for more than fifteen months at Lehman. Finally, Lehman's compliance record since 1994 – when the new Lehman Brothers emerged – is an enviable one with not a single regulatory action initiated relating to our Private Client Services business.